Disallowance of expenses u/s 14A

QUESTION: In all cases where a taxpayer has some exempt income or other, it is not unusual for the assessing officers to attribute normal business expenditure to such exempt income. This creates much hardship especially in those cases where the assessee has income from dividend with no expenses incurred but all the same expenditure against taxable income is disallowed quite often with reference to Rule 8D in proportion to investments leading to a very large disallowance resulting in an assessment on income larger than the real income often exceeding exempt income itself. It is understood that the provision under Sec. 14A including Rule 8D has been found to be constitutionally valid. What is the remedy for a large number of taxpayers affected by this provision?

ANSWER: Sec. 14A like many other provisions of similar nature is meant to prevent abuse of the provisions of law. Where taxpayers shift expenditure from non-taxable income to taxable income avoiding tax thereby, it becomes a case of abuse of process of law working to the detriment of the revenue. But where the provision is applied by the officers with excessive zeal, it may equally be an instance of abuse of this very provision. Sec. 14A itself should be applicable even as provided under sub-section (3) only where no such expenditure has been claimed to have been incurred or such expenditure claimed is not correct. Where no expenditure at all has been incurred, the fact that there is no claim of any expenditure cannot justify application of Sec. 14A and much less application of Rule 8D. Any other view would be neither fair nor justified.

The inference that dividend income is exempt is not correct in real terms, since tax is paid as dividend distribution tax under Sec. 115-O. It should not make any difference whether tax is collected from the company distributing the dividend or the shareholder. This argument, which failed before the Special Bench of the Tribunal in Cheminvest Ltd. v ITO [2009] 317 ITR (AT) 86 (Del)[SB] and ITO v Daga Capital Management Pvt. Ltd. [2009] 312 ITR (AT) 1 (Mumbai)[SB] has still some life as the view taken in these cases is too technical.

No distinction is being made by the assessing officers as between cases where the investments in shares have been made as a dealer or as an investor as decided in the above cases.In the case of a dealer, he makes investments in shares not with a view to deriving income from dividend but to realise the appreciation in the market value of the shares. He makes investments in shares even by borrowing. When investment in shares is his business, the borrowing is for business and not for earning the exempt dividend income for purposes of Sec. 14A. Interest payments are, therefore, deductible only against business income.

In the context of set-off of the loss under one head against the same head, the courts have held that whatever be the head, whether interest on securities or property, they would have the character of business income for purposes of set-off when they are earned during the course of business, since the classification

as between the heads of income is only for the limited purpose of computation of income and not for other purposes as, for example, held in CIT v Cocanada Radhaswamy Bank Ltd. [1965] 57 ITR 306 (SC) and CIT v Chugandas and Co. [1965] 55 ITR 17 (SC) and a number of other cases. There should, therefore, be no disallowance for interest on borrowed capital, if it could be shown to be the borrowing cost of legitimate business permissible under Sec. 36(1)(iii) of the Act.

As for the investors, a reasonable expenditure attributable to such investments may have to be allowed against exempt income by shifting from expenditure against taxable income, where justified on facts only where the pre-condition for application of Sec. 14A are satisfied as noticed earlier. But where Rule 8D is applied or any other Rule is followed, such amount may well be cost or cost of improvement of the assets (shares) so that it gets allowed in computation of capital gains. Such a stand should be permissible where the assessee fails to contest the disallowance on merits following the decisions of the High Courts in CIT v Mithilesh Kumari [1973] 92 ITR 9 (Del), Addl. CIT v K.S. Gupta [1979] 119 ITR 372 (AP) and CIT v Maithreyi Pai [1985] 152 ITR 247 (Karn). But where capital gains arise on sale of listed shares through a stock exchange after payment of securities transaction tax, this treatment of expenses as cost would make no difference to liability, since no tax is payable on such long-term capital gains.

Source: The Hindu